IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No.

SKENANDOA RAYON CORPORATION,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Brief in Support of Petition for Writ of Certiorari.

Opinions.

The opinion of the Circuit Court of Appeals for the Second Circuit (Circuit Judges L. HAND, SWAN and AUGUSTUS N. HAND, Judge SWAN writing) was filed July 31, 1941, and appears at page 128 of the record. It is reported in 122 F. (2d) 268. An opinion was delivered by the Board of Tax Appeals. It was written by Hon. RICHARD L. DISNEY and promulgated on November 26, 1940. It appears at page 83 of the record and is reported in 42 BTA 1287.

Jurisdiction.

The jurisdiction of this court arises by virtue of the provisions of Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, c. 229 (43 Stat. 938; 28

U. S. C. Sec. 347.) The judgment of the Circuit Court of Appeals for the Second Circuit was entered August 16, 1941 (Record, p. 131, fol. 133). This petition for certiorari and brief was filed prior to November 16, 1941.

The United States Board of Tax Appeals affirmed the determination by the Commisioner of Internal Revenue of the deficiency in the income tax of the petitioner for the taxable year 1937 in the amount of $54,873.09, and a deficiency in the excess profits tax for the same year in the amount of $706.87 (106). Such order was affirmed by the United States Circuit Court of Appeals for the Second Circuit (R., p. 131, fol. 133). The Circuit Court of Appeals for the Second Circuit (as well as the Board of Tax Appeals) held that the transaction was a tax free exchange (except for the cash payment of $5.50 per share) as an incident to a reorganization and recapitalization, within the provisions of Sections 112(b) (2) and (3), (c) (1), (g) (1) (D) and 115(h) (1). (R. 283, 284; R. pp. 128-131, fols. 128-132.)

The Facts.

The facts are stated in the petition at pages 4 to 8. The findings of fact of the United States Board of Tax Appeals appear in the record at pages 66-83, fols. 196-247.

ARGUMENT.

Summary.

The Circuit Court of Appeals has decided an important question in the administration of the federal income tax laws in a way untenable because in conflict with the ex-

press provisions of the Revenue Act of 1936 and the decisions of this court. Such question has not been, but should be, settled by this court.

The application of 1937 earnings as the consideration for the issuance of additional preferred stock in discharge of accumulated arrears of dividend was in effect the distribution of a cash dividend taxable to the recipients in the amount of said earnings under Section 115(a) or (g) of the Revenue Act of 1936. The Circuit Court of Appeals, however, did not so hold.

In the alternative, the additional preferred stock issued in discharge of accumulated arrears of dividend gave the recipient stockholders a proportional interest in the net assets of the corporation which was essentially different from their former interest, and, consequently, the preferred stockholders received income taxable under the Sixteenth Amendment. The decision below is in conflict with the provisions of Section 112(c) and 115(f) of the Revenue Act of 1936 and the decisions of this Court in *Koshland* v. *Helvering*, 298 U. S. 441, and *Helvering* v. *Gowran*, 302 U. S. 238.

The distribution of additional preferred stock was not a tax-free exchange incident to a reorganization by recapitalization under the provisions of Section 112 of the Revenue Act of 1936. The distribution was taxable under the express provisions of Section 112(c)(1) and (2). Legal expenses incurred in carrying out the transaction were operating expenses deductible from gross income under Section 23(a).

POINT I.

The application of $222,120 of petitioner's earnings for the year 1937, with the consent of the holders of 5,553 shares of petitioner's outstanding preferred stock, as the consideration for the issuance of 2,221.2 additional shares of petitioner's new preferred stock, or at the rate of .4 of a share in respect of each of the 5,553 consenting shares, in discharge of $40 of accumulated arrears of dividend, as set forth in the plan, was, in effect, the distribution of a cash dividend in the said amount from petitioner's earnings and profits accumulated during the year 1937.

There can be no doubt that the primary purpose of the proposal offered to petitioner's preferred stockholders under the plan was to effect an adjustment of the arrears of dividends on the outstanding shares of petitioner's old cumulative preferred stock. Such purpose was implicit (if not expressly stated) in all that was presented to the stockholders in the statements made in the plan and an accompanying letter addressed to petitioner's stockholders. The preferred stockholders were informed that "the arrears of accumulated dividend on the Convertible Preferred Stock, as at July 1, 1937, amount to $45.50 per share, or the aggregate of $256,256" (75, 162*). They were also told "The need for a plan of readjustment of the present capitalization arises principally as a result of the substantial amount of unpaid accumulated dividends on the outstanding Convertible Preferred Stock, which * * * should not be paid in cash at this time. Furthermore, it is also desirable that the Corporation retain its present working capital to finance the purchase of addi-

* Figures in parentheses, unless otherwise indicated, refer to folios in the transcript of the record in the Circuit Court of Appeals.

tional machinery and equipment desired to handle the substantial increase in the volume of business which is taking place." (203)

The plan and accompanying letter also stated (in heavy black type) that in accepting the plan "By making the exchange holders of the existing Cumulative Preferred Stock will thereby release, relinquish and discharge their claim to all dividends accrued and in arrears on the outstanding Cumulative Preferred Stock." (98, 171, 219)

The provisions of the plan and the effect thereof as a dividend distribution must have been clearly understood and found acceptable by an overwhelming majority of the holders of petitioner's preferred stock, because out of 5,632 issued shares, the holders of 5,553 shares, all but 79 shares, accepted the proposal. The preferred stockholders who accepted the proposal thereby elected to accept in discharge of the arrears of $45.50 per share .4 of a share ($40 face value) of additional new prior preferred stock, 5% convertible series, of the par value of $100 per share, and $5.50 in cash in respect of each issued share of old preferred stock then held. The holders of the 79 shares who did not accept the proposal elected to stand on their existing right to receive in cash the full arrears of $45.50 per share.

In this connection, it should be pointed out that Section 115 (f)(2) of the Revenue Act of 1936 (discussed *infra* at page 28) provides that where a distribution by a corporation is "at the election of any of the shareholders * * * payable either (A) in its stock, or * * * (B) in money or any other property * * *, then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid."

It cannot be disputed that under the law of the State of Delaware, where petitioner was incorporated, the right

to arrears of dividend on cumulative preferred stock is a contractual, property right of which the stockholder may not be deprived without his voluntary consent.

> *Keller* v. *Wilson,* 190 Atl. 115 (Del. Supreme Court, 1936).

The same rule has been held to apply in various other states.

> *Strout* v. *Cross, Austin & Ireland Lumber Company,* 283 N. Y. 406;
> *Davison* v. *Parke, Austin & Lipscomb, Inc., supra,* 285 N. Y. 500;
> *Lonsdale Securities Corporation* v. *International Mercantile Marine Co.,* 101 N. J. Eq. 554;
> *Patterson* v. *Durham Hosiery Mills,* 214 N. C. 806;
> *Harbine* v. *Dayton Malleable Iron Co.,* 22 N. E. (2d) 281 (Ohio Court of Appeals, 1939).

Therefore, in accepting petitioner's proposal, it may be truly said that the holders of petitioner's old preferred stock exercised their optional right to elect that the petitioner's earnings be distributed to them in cash as required by their existing contracts and without any understanding that it be re-invested in additional shares of petitioner's new prior preferred stock, or that the earnings be distributed subject to the agreement set out in petitioner's proposal.

For the purpose of determining whether the transaction had the effect of the distribution of a taxable dividend and constituted income taxable under the Sixteenth Amendment, there appears to be no valid ground for drawing a distinction between the distribution made to the holders of 79 shares who did not accept the petitioner's proposal

and the distribution made to the holders of the 5,553 shares who did accept the provisions of the plan. In either case, the amount distributed from petitioner's 1937 earnings with respect to each share of preferred stock was exactly the same; and it necessarily must have been the same in order to satisfy and discharge the contract right to be paid the arrears of $45.50 per share.

The shares of petitioner's new prior preferred stock were of the par value of $100 per share. Under Section 14 of the General Corporation Law of Delaware, capital stock having a par value can only be issued as fully paid stock if the corporation receives capital in a total amount equal to the par value of the shares issued. The transfer of $222,120 from petitioner's 1937 earnings to its capital account constituted the receipt of the capital for the issuance of 2,221.2 shares of new preferred stock of the par value of $100 each, so that the new shares were validly issued as fully paid and non-assessable shares. It necessarily follows, therefore, that the holders of the 5,553 shares of preferred stock who consented to the provisions of the plan and received the new stock, were, in effect, the recipients of a distribution from petitioner's 1937 earnings which was the equivalent of a cash distribution of $222,120.

In substance and effect, the transaction was the same as if $222,120 of petitioner's 1937 earnings had been distributed directly to the holders of the 5,553 shares and immediately on the receipt thereof such stockholders purchased from petitioner, at par, 2,221.2 shares of new preferred stock and made payment for the new stock with the cash distributed to them by petitioner.

There was nothing in the tax law which prevented petitioner from reaching an understanding with its own preferred stockholders prior to the distribution of a dividend

that the stockholder receiving such dividend would re-invest an agreed amount thereof (here it was $40 per share) in additional shares of petitioner's new prior preferred stock. In essence, that was the effect of the petitioner's offer to its preferred stockholders.

When the substance and effect of the transaction are understood, we believe it is plain that, with their express consent, the holders of 5,553 shares of petitioner's preferred stock received from petitioner's 1937 earnings the equivalent of $222,120, which is taxable income to them within the meaning of the Sixteenth Amendment, and that petitioner is entitled to a dividends paid credit in that amount.

There can be no doubt that in good faith petitioner transferred and applied $222,120 of its 1937 earnings to capital account as the consideration for the issuance of the 2,221.2 additional shares of its new prior preferred stock. By that action (to which the holders of 5,553 shares of petitioner's old preferred stock gave their consent) the stated amount was irretrievably taken from petitioner's earnings. The transaction effectively diminished petitioner's earned surplus by the amount stated. Furthermore, by issuing the 2,221.2 additional shares of stock, petitioner irrevocably assumed all of the burdens imposed upon it by the provisions of the certificates for the additional shares of new prior preferred stock and the stockholders who received such new shares thereby acquired additional proportionate interests in the net assets of the corporation and additional voting rights substantially different from those held prior to the receipt of the new shares (cf. *Koshland* v. *Helvering,* 298 U. S. 441, discussed *infra*).

The distribution of the additional shares of petitioner's new prior preferred stock in satisfaction of $40 of arrears

of dividend per share on petitioner's old preferred stock, we submit, was in all respects in accordance with the announced objects and purposes of the surtax on undistributed earnings, i. e., to compel corporations to distribute earnings so that the recipient stockholders could determine whether they wished to reinvest such earnings in additional shares of their corporation (See President Roosevelt's message to the 74th Congress, 2nd Session, March 3, 1936, and see Report of Ways and Means Committee, Report No. 2475, House of Representatives, 74th Congress, 2nd Session).

The learned court below and the Board of Tax Appeals, it appears, failed to appreciate the essential nature of the transaction from the point of view of the receipt of taxable income to the consenting preferred stockholders. Furthermore, the court below did not properly appraise the actual substance and effect of the transaction in relation to the applicable provisions of the Revenue Act of 1936.

It is our belief that the provisions of the 1936 act sustain petitioner's contentions. A dividend is defined in Section 115(a) of the act as follows:

> "The term 'dividend' when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

This court has said repeatedly that the substance and not the form of a dividend transaction is the controlling element.

U. S. v. *Phellis,* 257 U. S. 156;
Rockefeller v. *U. S.,* 257 U. S. 176.

Furthermore, a distribution actually made from earned surplus, as here, is a dividend irrespective of the form the distribution takes. As was observed by Judge SIBLEY in *Rose* v. *Little Investment Co.,* 86 F. (2d) 50, 51 (C. C. A. (5) 1936):

> "* * * The word 'dividend' means primarily the thing to be divided, and not the results of the division, and this meaning is observed in mathematics."

Instead of distributing $222,120 of its 1937 earnings in cash and receiving the same amount back from its stockholders as the payment for 2,221.2 shares of new preferred stock issued at par, petitioner, with the consent of the holders of 5,553 shares of its preferred stock, capitalized that amount of its 1937 earnings as the consideration for the issuance of the 2,221.2 new shares in satisfaction and discharge of $40 of the accumulated arrears of dividend per share on the consenting preferred stock. It seems irrefutable that such a transaction constituted a distribution of earnings by the petitioner corporation within the meaning of Section 115(a) of the Revenue Act of 1936.

It was a "distribution made * * * whether in money or other property * * * out of the earnings or profits * * * of the taxable year * * *."

It is not disputed that petitioner's net earnings for the taxable year 1937, after deductions for federal income taxes, amounted to $352,055.33 (244), so the earnings were more than adequate to cover the distribution as made.

The Revenue Act of 1936 made an addition to the definition of "dividends", as stated in prior revenue acts, by including in Section 115(a) a provision for a distribution

"(2) out of the earnings or profits of the taxable year * * * without regard to the amount of the earnings and profits at the time the distribution was made." According to the report of the Senate Finance Committee, the purpose of this addition was stated as follows:

> "Section 115(a)—Dividends Out of Current Earnings. In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, Section 115(a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividends paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary." (Senate Finance Committee, Report No. 2156, 74th Congress, Second Session, pp. 18-19)

It is respectfully submitted, therefore, that the distribution of the 2,221.2 additional shares of petitioner's new prior preferred stock constituted the payment of a "dividend", as defined by Section 115(a), and it was the equivalent of a distribution in cash of $222,120 from the petitioner's earnings for the taxable year 1937.

Furthermore there should be noted the express provisions of Section 115(g) of the Revenue Act of 1936 providing that "If a corporation cancels or redeems its stock * * * at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or

cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

The exchange of 1.4 shares of new prior preferred stock (and $5.50 in cash) for 1 share of old preferred stock (which old stock was surrendered and cancelled) may also be considered as a cancellation of the old shares "in such manner as to make the cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend" and the "amount so distributed" held to "represent a distribution" of petitioner's 1937 earnings. So considered, the distribution is clearly to be treated as a taxable dividend.

In the following points we shall show that the distribution was taxable to the recipients under the Sixteenth Amendment.

POINT II.

Since the receipt of the 2,221.2 shares of petitioner's additional preferred stock under the provisions of the plan gave the recipient stockholders a proportional interest in the net assets of the corporation after the distribution, which was essentially different from such stockholders' former interest, the preferred stockholders receiving such distribution received income taxable under the Sixteenth Amendment.

There can be no dispute, we believe, that if the $222,120 of petitioner's 1937 earnings had been distributed in money, free of any understanding previously made with the preferred stockholders regarding reinvestment of the money in additional shares of petitioner's preferred stock, the recipients would have received a dividend which would constitute taxable income.

The primary contention of petitioner, both before the Board of Tax Appeals and the court below, was that the proposal contained in petitioner's plan and the acceptance thereof by the stockholders, when carried out by petitioner, was the equivalent of a distribution in cash.

As a second and alternative contention, petitioner's counsel took the position that the distribution of the 2,221.2 additional shares of preferred stock might be considered as constituting a stock dividend, inasmuch as the distribution gave the recipients a proportional interest in the net assets of the corporation different from the interest they held before the distribution.

The pertinent provisions of Section 115 (f)(1) of the Revenue Act of 1936 read as follows:

> "(f) Stock Dividends.
>
> (1) General Rule. The distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

We have seen that the holders of 79 shares of preferred stock did not accept petitioner's proposal, but elected to stand on their rights to be paid the full arrears in accordance with the provisions of the preferred stock preferences and free of any other understanding with petitioner, as proposed in the plan.

In the circumstances, therefore, we believe it may be truly said that the preferred stockholders had a right of election or option whether to stand on their contractual rights to be paid the dividend in money or to accept petitioner's proposal, and thereby elect to accept the divi-

dend partly in money and the balance (i. e., to the extent of $40 per share) in new preferred stock of petitioner.

Section 115(f)(2) of the Act contains the following provision:

> "(2) Election of Shareholder as to Medium of the Payment. Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or * * *(B) in money or any other property * * *, then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid."

Under the law of Delaware and in view of the provisions of the contract represented by the certificates for outstanding shares of preferred stock, it is clear that petitioner's preferred stockholders could insist upon their right to be paid the full amount of the arrears in cash.

> *Keller* v. *Wilson,* 190 Atl. 115 (Sup. Ct. of Del, 1936).

Petitioner, having pointed out in the plan that the arrears "should not be paid in cash at this time" (203), presented to the preferred stockholders an alternative basis for the satisfaction of the arrears of dividend by accepting the proposal stated in the plan.

In such circumstances, we believe it may properly be said that the preferred stockholder did have a right of election as to the medium of payment within the meaning of Section 115(f)(2) of the Revenue Act of 1936.

If we are correct in that view, then it necessarily follows that Congress intended that the distribution in stock, as well as in money, should constitute a taxable dividend

in the hands of all of the shareholders receiving the distribution "regardless of the medium in which paid".

In other words, that section of the act appears designed to prevent the drawing of any distinction between holders of the same class of stock, i. e., the holders of the 79 non-assenting shares and the holders of the 5,553 assenting shares, in determining whether "the money or any other property" (here shares of stock) received by either of the two groups of preferred stockholders shall be considered as taxable income.

It is also the petitioner's contention that within the rules stated by this court in *Koshland* v. *Helvering, supra* (298 U. S. 441), and *Helvering* v. *Gowran, supra* (302 U. S. 238), the distributions made by petitioner to discharge $40 of the arrears of dividend on 5,553 shares of petitioner's preferred stock is to be treated as income upon which Congress may levy a tax.

In *Koshland* v. *Helvering, supra,* shares of common stock were received by holders of cumulative preferred stock as dividends. It was held by this court that the receipt of such dividend of common stock on preferred stock constituted income within the meaning of the Sixteenth Amendment, because of the change in the proportional interest of the stockholder which resulted from the distribution. At that time, however, it did not appear that Congress had taxed the receipt of such income.

In *Helvering* v. *Gowran, supra,* dividends of preferred stock were distributed to common stockholders. This court held that under the rule announced in the *Koshland* case Congress could have taxed such dividends, although in the provisions of Section 115(f) of the Revenue Act of 1928 it had expressly provided that "a stock dividend shall not be subject to tax".

Apparently in the light of those decisions, when the Revenue Act of 1936 was enacted, Section 115(f) was changed, as above indicated, so that a distribution made by a corporation to its shareholders in stock may be treated as a dividend to the extent that it constitutes income to the shareholder within the meaning of the Sixteenth Amendment.

Therefore, where, as here, the distribution does increase the proportional interests of the recipient stockholders, it constitutes income to the shareholder within the meaning of the Sixteenth Amendment, which, under the provisions of Section 115(f)(1) and (2) of the Revenue Act of 1936, was taxable to the recipient stockholder.

The rule for which petitioner contends here appears to have been recently stated by the Circuit Court of Appeals for the Ninth Circuit in *Sprouse* v. *Commissioner of Internal Revenue,* —— F. (2d) ——, decided October 22, 1941 (unofficially reported in 414 CCH, Federal Tax Service, 1941, Vol. IV, paragraph 9703, page 10,647), where the court held that the test to be used in determining whether a stockholder who receives a dividend in stock of the distributing corporation has received income, is whether the distribution effects a change in the proportionate interest of the stockholders, thus following the rule stated by this court in *Koshland* v. *Helvering, supra,* and *Helvering* v. *Gowran, supra.* As hereinafter pointed out, the court below gave no consideration to the application of such test, although its attention was directed to such test, as stated in the decisions of this court.

In support of petitioner's alternative contention that the issuance of the additional shares of new preferred stock might be treated as the equivalent of a stock dividend (292), petitioner conceded on the record before the Board of Tax Appeals that the fair market value of the new preferred

stock, based upon the sale of a few shares made during the year 1937, was not less than $84 per share (297). That concession was apparently acceptable to counsel for the respondent Commissioner (367).

In the brief of petitioner in the court below, as well as before the Board, petitioner's counsel argued that in the alternative the distribution might be considered as a stock dividend (254).

However, in the opinion of the Board of Tax Appeals it was said that there was no evidence adduced to show fair market value and that the Board member confined his decision to the question whether the transaction should be given the effect of a cash dividend, taxable and paid (254).

In the light of that statement, petitioner's counsel then applied to the Board of Tax Appeals to have the case reconsidered or reopened to enable petitioner to produce competent proof of the fair market value in 1937 of the shares of petitioner's new preferred stock, or that the case and the opinion be reviewed by the full Board (286). That application was denied (310).

The court below held that the Board's denial of petitioner's application to reopen the case to enable petitioner to prove the fair market value of petitioner's new preferred stock at the time of its issue "rests in the sound discretion of the Board" and that "we can see no abuse of discretion" (R. 131, fol. 132). But the court apparently overlooked the fact that the denial of the application was in connection with the Board's holding that the distribution was a non-taxable exchange and as an incident of a reorganization within the purview of Section 112(b)(2), (3) and (c)(1) and 112(g)(1)(D) of the Revenue Act of 1936 (283, 284). It is apparent, therefore, that the Board's denial of petitioner's application to reopen the case was in the belief that further evidence relating to the market

value of petitioner's new preferred stock was either unnecessary or would not change the result. Thus the Board's denial of petitioner's application was not in the exercise of a discretionary power, but a part and parcel of the Board's (erroneous) determination that the distribution made by petitioner did not constitute taxable income; and that determination was made irrespective of whether the distribution was a cash dividend or a distribution of preferred stock.

POINT III.

The issuance and distribution by petitioner of 2,221.2 additional shares of its new prior preferred stock to the holders of 5,553 shares of its old preferred stock was not a tax-free exchange incident to a reorganization by recapitalization, under the provisions of Section 112 of the Revenue Act of 1936. The distribution was taxable under the express provisions of such Section 112. Legal expenses incurred in carrying out the transaction were operating expenses deductible from gross income.

Both the court below and the Board of Tax Appeals accepted the argument advanced by the Commissioner that the transaction was a recapitalization and that within the language of Section 112(b)(2) and (3) of the Revenue Act of 1936 the capital gain or loss to the preferred stockholders who accepted petitioner's proposal was limited to a recognition of the amount of cash received at the rate of $5.50 per share (261 and see opinion below, R. p. 129, fols. 129, 130).

However Section 112(c)(1) reads as follows:

> "(c) GAIN FROM EXCHANGES NOT SOLELY IN KIND.
>
> "(1) If an exchange would be within the provisions of subsections (b) (1), (2), (3), or (5) of this section

> if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, *but also of other property or money,* then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property." (Italics supplied.)

Apparently it was the provisions of the foregoing section upon which the court below and the Board of Tax Appeals relied for the conclusion that a gain from the distribution in settlement of arrears of dividend would be recognized only to the extent of $5.50 per share. Although it was brought to the attention of the court below, no consideration was given to the fact that not only was the $5.50 "other property or money" within the meaning of Section 112(c)(1), but also that the additional preferred stock distributed in settlement of dividend arrearages came within such subsection.

Notwithstanding that it was expressly pointed out in petitioner's brief below, no consideration was given to the provisions of Section 112(c)(2), which reads as follows:

> "(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection *but has the effect* of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. * * *" (Italics supplied.)

Under that section, even if the transaction is to be considered as a "distribution made in pursuance of a plan of reorganization", Congress has clearly indicated that if the distribution "has the *effect* of the distribution of a taxable dividend", which we believe is the case here, the

distribution must be taxed as a dividend where the distribution is not in excess (as is the case here) of the preferred stockholders' ratable shares of petitioner's undistributed earnings and profits accumulated in 1937 which, of course, was after February 28, 1913.

Section 112(c)(2) further indicates that even though in form and terminology there may be found a "plan of reorganization" by means of which a distribution of earnings is made, nevertheless it is necessary to examine such plan of reorganization to ascertain whether the "effect" of carrying out such a plan is to distribute a taxable dividend.

As we have shown above, the transaction between petitioner and its preferred stockholders plainly had the effect of distributing petitioner's 1937 earnings which increased the proportionate interest of the recipients in the net assets of petitioner. That being so, the distribution under the so-called "plan of reorganization" has had "the effect of the distribution of a taxable dividend," the amount of which is not in excess of the ratable shares of each preferred stockholder in petitioner's undistributed earnings accumulated after February 28, 1913.

Therefore, our situation comes squarely within the provisions of Section 112(c)(2); and even if the carrying out of the plan is to be considered as a technical "plan of reorganization", nevertheless the effect thereof was the distribution of a taxable dividend.

The court below took the view that there was an "exchange of preferred stock solely for preferred stock" in the same corporation within the meaning of Section 112(b)(2), which provides:

> "No gain or loss shall be recognized if common stock in the corporation is exchanged solely for common

stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation".

Rights to arrears of accumulated dividends on preferred stock, however, are not "preferred stock" within the meaning of Section 112(b)(2). Holders of cumulative dividend preferred stock have a vested right to unpaid arrears of dividend of which they can not be deprived without their consent (*Keller* v. *Wilson, supra,* 190 Atl. 115). Consequently, the issuance and receipt of the 2,221.2 shares of new preferred stock in settlement of arrears of dividend was not a receipt of preferred stock "solely in exchange for preferred stock", and the gain resulting from the exchange of the right to such arrears of dividend for such additional new preferred stock was taxable under Section 112(c)(1) and (2).

The lower court apparently went to great lengths in an effort to bring the transaction within the provisions of Section 112(b)(3), which provides:

> "(3) Stock for Stock on Reorganization.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

The court below said in its opinion (R. 130, fol. 131):

> "Even were we to accept the argument that the right to arrears of undeclared dividends was something in addition to the shares, and consequently the exchange was not 'solely' stock for stock, the taxpayers' path would be blocked by Section 112(b)(3). The stockholders' rights to dividend arrears, if treated as separate from the stock itself, must certainly be considered as 'securities in a corporation a party to a reorganization'—a curious 'security' to be sure,

> but nevertheless a 'security'. The rights represented by accumulations of preferred dividends are rights to share in future earnings of the corporation in preference to common stock; as such they represent such a continuity of interest in the affairs of the corporation as to constitute them 'securities'. Cf. *Lloyd-Smith* v. *Commissioner,* 116 F. 2d 642 (C. C. A. 2). It cannot be denied that there was a recapitalization and hence a 'reorganization' within the definition described by section 112(g)(1)(D). Hence section 112(b)(3) would preclude the recognition of gain or loss. Except to the extent of the cash payment, as provided in section 112(c)(1), the distribution to the old shareholders was not taxable."

In treating a right to arrears of dividend as a "security", it is submitted that the court below strained severely the ordinary meaning of the term "security".

It is elementary that until a dividend has been set apart or declared the stockholder has no rights whatever therein.

> *Gibbons* v. *Mahon,* 136 U. S. 549, 558;
> 11 Fletcher Cyclopedia Corporations, § 5321, pp. 781-786.

While holders of cumulative preferred stock have a vested right to accumulated arrears of dividends of which they can not be deprived without their consent and while such right, as demonstrated above, is distinguishable from the stock itself, such right to arrears of dividend does not constitute a "security". It has none of the attributes of a security. It is not a note, bond, debenture, stock or any other instrument commonly known as a security. It is more analogous to a contingent equitable claim, since until a dividend has been declared and profits are thereby set apart for its payment the stockholder has no claim at law. While the right to arrears of dividend might be within those inapplicable paragraphs of Section 112(b), concern-

ing the exchange or transfer of "property", such vested right is not "preferred stock" or "stock or securities" within paragraphs (2) and (3) of Section 112(b).

As stated in Article 112(a)-1 of Treasury Regulations 94, relating to corporate reorganizations, "the exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception." Moreover, this Court has heretofore interpreted certain of such exceptions relating to corporate reorganizations strictly and has held that promissory notes or bonds received in exchange for property in a reorganization were not "securities" within the meaning of that term.

> *LeTulle* v. *Scofield,* 308 U. S. 415;
> *Pinellas Ice Co.* v. *Commissioner,* 287 U. S. 462;
> *See also Helvering* v. *Bashford,* 302 U. S. 454.

Accordingly, there would seem to be no valid ground for the holding of the court below that a right to arrears of dividend is a security, especially since the effect thereof is to broaden the restrictive exceptions to the general rule of taxability, thereby increasing tax exemptions.

The Board of Tax Appeals took a somewhat different view for holding that the exchange came within the provisions of Section 112(b)(2), (3) and (c)(1), saying:

> "* * * One consideration appears for both the release of the old stock and the release of the right to accumulated dividends.
>
> "From all this we conclude that a consideration for the exchange is not separable between old stock and the right to dividends accumulated thereon. * * *"
> (276, 277)

The basic error in the court below and before the Board of Tax Appeals was the failure to examine the substance of the transaction, rather than its form. The Circuit Court of Appeals, as well as the Board, erred in failing to hold that the *effect* of the distribution was a taxable dividend within the meaning of Section 112(c)(2) of the Revenue Act of 1936. Neither the court below nor the Board gave any consideration to the provisions of that section.

Since the distribution of the new prior preferred stock in settlement of $40 of arrears of dividend per share on the old preferred stock was not a tax-free exchange and is taxable in the hands of the recipients, the sum of $15,000 paid by petitioner for legal expenses in carrying out the transaction is clearly an ordinary and necessary operating expense which petitioner is entitled to deduct from its gross income in accordance with Section 23 (a). The distribution of taxable dividends on the petitioner's outstanding preferred stock and the securing of working capital to provide for current expansion does not appear to be an ordinary and necessary expense incurred in carrying on petitioner's trade or business.

CONCLUSION.

For the reasons stated, a Writ of Certiorari to the Circuit Court of Appeals for the Second Circuit should issue.

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Respectfully submitted,

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